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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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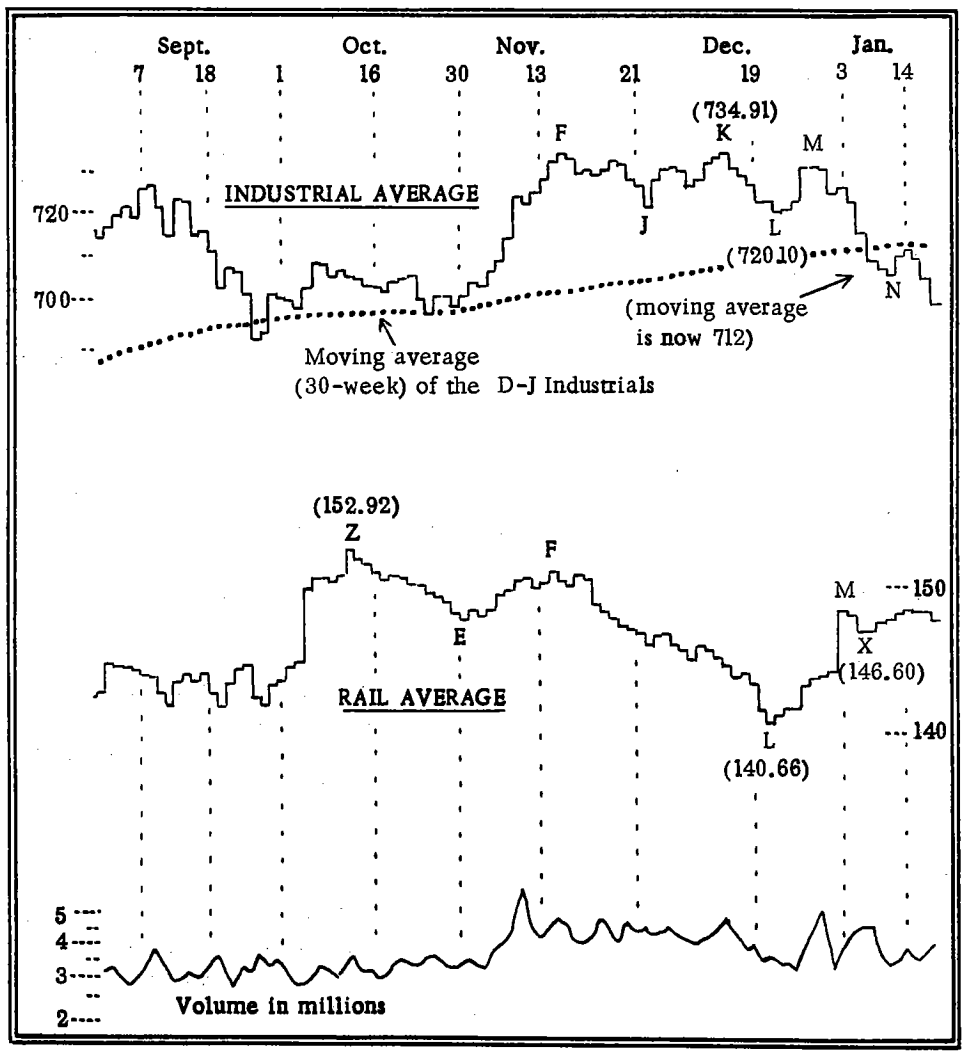
THE MARKET Recent Letters have called repeated attention to the fact that the two Averages have been unable to remain "in gear" over any reasonable length of time. Because of this, the chart on this page continues to portray a complex and confusing picture.

Following the historic Industrial high of 734.34 (F), the senior Average declined briefly to 721.60 (J). Subsequently (against a steadily declining Rail group) Industrials rallied to a fractional all-time high of 734.91 (K), then turned down to "test" the preceding J level. At L (720.10), Industrials penetrated J by 1.5 points but volume contracted noticably. This seemingly "false" penetration gave way to a disappointing 11 point "year-end rally", a rally which failed (at M) to better the December 13 (K) high of 734.91.

The New Year was greeted by a fresh decline. On January 5, Industrials violated the L (720.10) level on expanding volume of 4.63 million shares. This penetration represented the first high-volume breaking of a preceding Industrial level since the entire rise began on October 25, 1960 (and attention was directed to this fact in the last Letter).

Inexplicably, the Rails (which had been the weaker group all during the final quarter of 1961) have been putting on a show of strength in this area. Following a bearish series of descending zig-zags (October through December), Rails rallied, and on January 12 the Rail Average actually rose above its preceding peak at M (148.33), thus forming a minor upward zig-zag. In view of the high Rail volume in this area (see Letter 167), however, I am not convinced that the Rails are as strong as might appear on the surface. Nevertheless, the current pattern of the Averages is a continuation of exactly what has been seen for the last ten months -- namely, a refusal of the two Averages to provide indications of broad strength or broad weakness (at no time since March 22, 1961, have the two Averages either risen to new high ground together or broken to new low ground together).



It is interesting to note how, time and time again, Industrial declines have tended to halt in the area of the moving average. The moving average is important because it represents the average price which investors are willing to pay over a reasonably long period (30-weeks or seven months) for a typical group of "blue-chip" stocks. During extended bull swings, the Industrials have a habit of holding (through all minor declines and consolidations) above their own moving average. A high volume plunge

 by Industrials well below the moving average usually represents an important reversal in investor sentiment. Such action suggests that investors have changed their evaluation of high grade stocks enough to drive the current price of thirty leading issues below their average price for the past seven months.

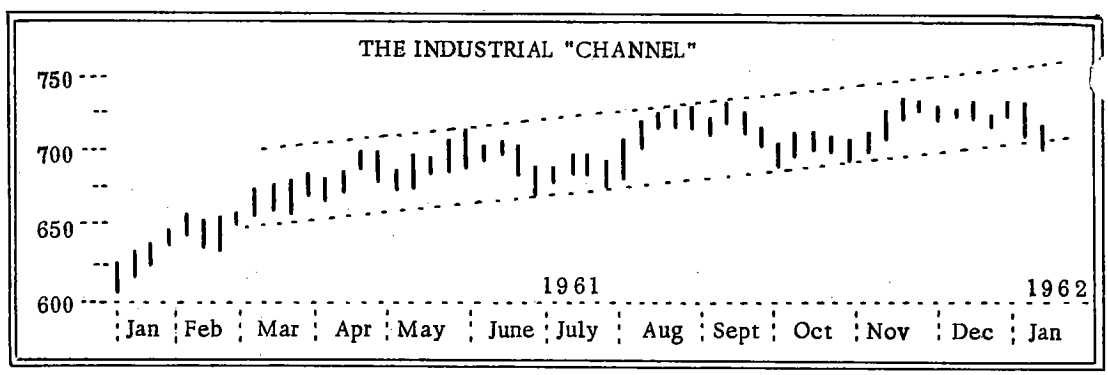
1961 witnessed two "tests" of the moving average (September and October -- see chart). On both of those occassions the Industrials penetrated the moving average by a point or so. Subsequent to each penetration, volume contracted and no further weakness appeared. Recoveries followed immediately.

Last week saw the third test of the moving average since October, 1960. As of this writing, the market performance has been less impressive than it was in either September or October of 1961 (see conclusion).

CONCLUSION The primary trend is taken to remain bullish. The secondary trend is still obscure but very probably is turning bearish. On January 16, Industrials (having rallied to just below the moving average) broke below their January 10 closing of 706.02 (N). This means that for the first time, they have formed a downward zig-zag below the moving average. A further decline on increasing volume taking Rails first below X (146.60), then below L (140.66) would confirm a secondary bearish trend and would be the most adverse indication in sixteen months. Conversely, a persistent refusal by Rails to violate one or both of those levels (X or L) would mean that some doubts are still warranted regarding the bearishness of the situation.

THE CHANNEL Letter 163 drew attention to the rising "channel" which has been formed by the Industrial Average over the past 10 months. "In the majority of cases," it was noted, "rising channels are eventually broken in a downward direction. By the same token, declining channels are usually broken in an upward direction. Occasionally, however, a rising channel will be broken upwards. When this occurs, the rallying force can be explosive".

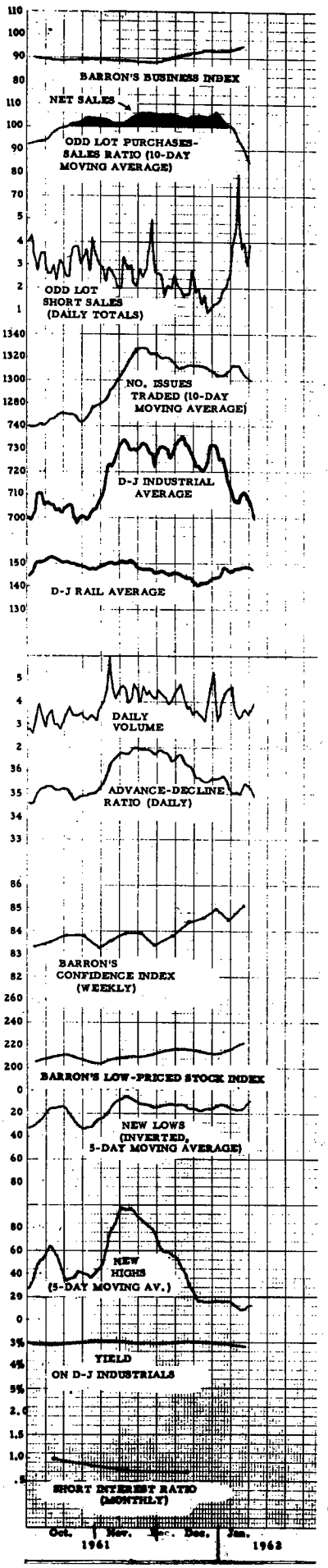
To bring this study up to date, the chart shows that the lower range of the channel is now at about 705. This week the lower channel line was barely penetrated on the downside. A break significantly below the 705 level on the Industrial Average would certainly suggest (on this study) that a reversal in trend had taken place.



SUNDRY COMMENTS When the Averages refuse to confirm each other, diverge, or simply turn down, there is no infallible guide which will tell the investor whether he is about to experience a minor decline, a secondary reaction or a major bear market. Almost all extended bull markets, however, have provided convincing "third-phase" characteristics prior to the ensuing bear market collapse. Some of these characteristics include low average yields, rampant speculation in low-priced stocks, rosy economic predictions, high volume, great interest on the part of the public regarding the market ("standing room only" in brokerage houses), and a general "feeling" among amateurs and professionals that the worst that can occur is "a permanently high plateau" for stock prices.

All of these phenomena were present during 1959, and they appeared again during late 1960 and early 1961. They are in evidence for the most part today. Against this viewpoint, the odd-lot statistics have not shown the type of excited "under-100-share" buying which has come to be associated with major tops. The advance-decline ratio has not diverged with the Industrial Average as is its habit at primary turns (had Industrials risen to a new high unconfirmed by the A-D ratio in late December, we would have seen the beginning of real divergence). Bank credit appraisals, which are offered by such excellent sources as Bolton-Trembley and the Harding Index, are emphatic in suggesting that (according to bank credit analysis) the worst that may be ahead is a secondary reaction. Among "informed opinion", I find a great deal of acceptance for (1) a possible secondary reaction at this time, (2) no major bear market at this time.

The old timers used to say: "You pays your money and you takes your choice". This writer, being a bit of a sceptic, would prefer not to pay his money at this time. The "choices" seem rather unappetizing and the market is not telling me a positive enough story. Many long-term investors are coming to the view that although "The Welfare State" may insure prepetual future prosperity for this nation, the savings banks are now providing an increasingly interesting measure of current prosperity (for instance, 4 to 4 1/2% interest in good New England banks).



INDICATORS Perhaps because of the extreme complexity of the current market, I have received numerous requests for another review of "the indicators" with this mailing. I hereby comply with the requests.

Odd-lot transactions (which are currently beyond the "new year" seasonal influences) are now well on the buy side. As such they can no longer be considered a short-term factor for strength (as was the case during most of 1961)..... Odd-lot short sales expanded sharply on the early January break, but this is a normal "first reaction" to weakness. If heavy odd-lot shorting continues, it will be a bullish indication..... The Confidence Index has climbed to a recovery high, a hopeful indication for the market a few months from now..... The advance-decline ratio has (as of this writing) performed no better than Industrials. The A-D ratio formed a downward zig-zag on January 17, thus confirming Industrial weakness. Rails are therefore the only price indicator now resisting the general decline..... New highs have dropped precipitously, but (so far) new lows have also held remarkably low. Until the new lows expand, we will not have a confirming indication of the weakness hinted at by the sagging new high index ..... I have added the short-interest ratio to the list, and this ratio is holding below 1.0 (which, though not definitely bearish, is certainly not a factor for strength in the current market)..... In all, the market indicators, except for the Rails and new lows, show few signs of strength. Broad weakness will be signalled by (1) increasing downside volume, (2) sharply expanding new lows, (3) persistent odd-lot buying during declines.

WORDS For the New Year, instead of a forecast, I offer some wise words. The words are not mine; they were written by Robert Rhea almost three decades ago.

"Operating in the stock market would be an ideal occupation if the Averages would only perform in accordance with some predetermined rule. Many students claim to have found the magic formula, and sometimes things seem to work for a while, but eventually the time always comes when fixed rules cause disaster.

Those who follow Dow's Theory frequently buy at the bottom, but they seldom sell at the top eighth, unless by accident.

I have never known a man who spent his days at brokerage offices for 10 years whose losses did not exceed his gains. I have frequently expressed the belief that neither Dow's Theory nor anything else can keep those benighted individual from wearing patched pants.

While the action of the Averages has appeared to be deceptive many times in the past, it is nevertheless true that , in the long run, their implications are more dependable than the opinions of well-informed individuals.

Hamilton once said that pride of opinion had led to the downfall of many traders. This is particularly true when applied to those who attempt to base their operations upon a mixture of personal opinions and the implications of the price movements.

The most usual form of wishful thinking is to accept the indications of the Industrial Average alone (when it will confirm the wisher's opinion), and to excuse the lack of Rail confirmation by arguing that it is valueless as an indicator because of this and that."

STOCKS Out of 56 "key" stocks which are watched at this office with particular care, 18 are now holding above their 10-week moving average. This is the poorest showing since this study was started three months ago.

I.B.M. is the largest institutional holding (in total value). Consequently, what this stock does is always worthy of note. During 1959 and early 1960, I.B.M. held above

the trendline marked A. During 1960 a second steeper trendline (B) was formed. As enthusiasm mounted, a third trendline (C) was traced, and this last trendline has been respected for over a year. During the past two weeks I. B. M. has broken a major trendline (C) for the first time in a number of years, and this in itself is significant. It has been a long time since I. B. M. has carried the label "technically" bearish.

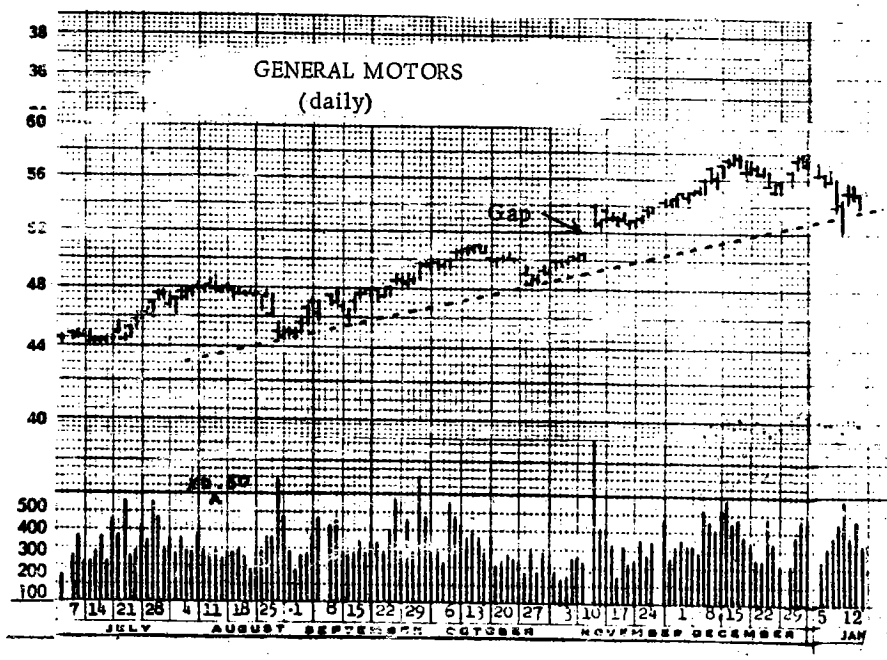
A second point of interest is the chart of General Motors, a "bellweather" of the market. In the face of record-breaking auto sales, the stock is looking "shakey". In November, G. M. surged sharply higher, thus forming the gap on the chart. During the past week G. M. has flirted with the bottom of the ascending trendline, while holding just above the gap. On January 17 G. M. closed at 53 1/2, which means that it closed below its trendline for the first time. It is now back in the previous area of extreme bullishness (the bullishness which caused the gap). A closing below 52 (below the gap area) would suggest to this writer that G. M. has suffered a complete reversal and belongs in the bearish catagory.

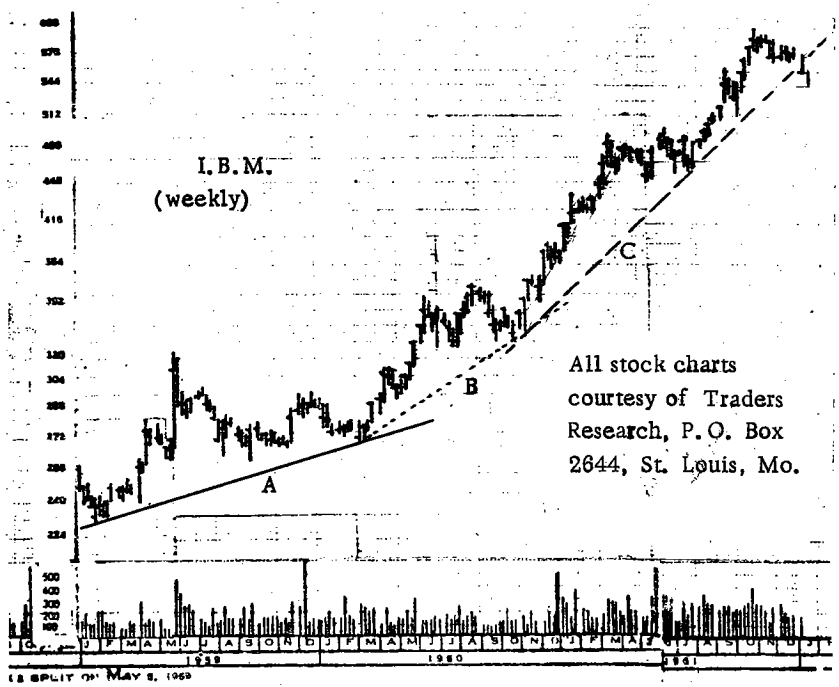
One of the spots of strength is North American Aviation (recommended at 52 in Letter 151). Not only has the stock held (as has Douglas -- see last Letter) above its ascending trendline, but it has managed to break above the trendline formed by two previous peaks. This implies a good deal of strength, and NV is one of the stocks which could resist general market weakness and lead on market strength. As such it should still be a good selection for traders.

LATE NOTES On January 18 Industrials dropped almost 8 points while Rails followed "in gear". The put Rails less than a point from X (146. 60). Volume increased, and I notice that for the first time since October, 1960, volume (over the last week or so) has had a tendency to expand with lower prices. This is obviously not comforting, and the market is beginning to look like a good sale on rallies.

The writer has an article scheduled for Barron's on Monday (January 22). I believe all subscribers should find the piece of interest.

(Written Thursday, January 18, 11 A.M. N.Y. time).





All stock charts courtesy of Traders Research, P. O. Box 2644, St. Louis, Mo.